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**Towards More Efficient  
Government: Reforming  
Federal Fiscal Relations in  
Germany**

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**TOWARDS MORE EFFICIENT GOVERNMENT : REFORMING FEDERAL  
FISCAL RELATIONS IN GERMANY**

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**by  
Eckhard Wurzel**

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## ABSTRACT/RÉSUMÉ

In Germany fiscal relations between the various levels of government have come to the fore of the policy debate. In practice the federal fiscal set-up has evolved towards consensus and co-operation, where equalisation of living standards takes precedence over public choice and economic incentives. Shared taxes and the low reliance on own taxes make for a relatively inefficient control over public spending. At the same time, the system may be criticised for not achieving economic convergence among the states. The difference in regional living standards is smaller than in some other economies, but the revenue equalisation system offers no incentives to expand the tax base and may even promote tax avoidance. Greater dynamism could be achieved with a less confiscatory equalisation system and a higher degree of tax autonomy and both of these should form part of any balanced tax and expenditure reform.

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Le débat politique en Allemagne s'intéresse depuis quelque temps aux relations budgétaires entre les divers niveaux d'administration. Dans la pratique le système fiscal fédéral a évolué dans le sens du consensus et de la coopération, l'harmonisation des niveaux de vie l'emportant sur les choix publics et les incitations économiques. Les possibilités d'exprimer des préférences régionales et locales en termes de dépenses publiques restent très limitées. Le partage des recettes fiscales et le recours très restreint aux recettes fiscales propres se traduisent par un contrôle relativement inefficace des dépenses publiques. Simultanément, on peut dire que ce système n'a pas permis d'assurer la convergence économique entre les Länder. Les différences de niveau de vie entre régions sont plus faibles que dans certains autres pays, mais le système de péréquation des recettes fiscales n'offre aucune incitation à accroître l'assiette des impôts et va même dans certains cas jusqu'à favoriser l'évasion fiscale. Une plus grande efficacité pourrait être obtenue grâce à un système de redistribution moins pénalisant et à une plus grande autonomie fiscale, deux aspects de toute réforme équilibrée des recettes et des dépenses publiques.

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## TOWARDS MORE EFFICIENT GOVERNMENT:

### REFORMING FEDERAL FISCAL RELATIONS IN GERMANY

Eckhard Wurzel<sup>1</sup>

#### Introduction

1. In a federal state, the drive to improve public sector efficiency and to produce a durable reform of the tax system naturally tends to bring fiscal relations between the various levels of government to the fore of the policy debate. In the current German context, there are several reasons why this focus is important. First, the integration of the new states is producing greater financial strains than anticipated, and as it has become increasingly evident that convergence will take some time, the danger has emerged that the incentive structure of existing financial relationships may be perverse: the system of inter-governmental transfers aimed at equalising revenue levels leaves little return to a state's efforts to improve its finances and two of the German Länder have recently appealed to the Constitutional Court since a political agreement on reform was not reached on the grounds that the high degree of redistribution of taxes is unconstitutional. Second, the Stability and Growth Pact at the European level has raised questions as to how the international commitments to fiscal consolidation can be efficiently and equitably allocated between different levels of government. Third, there is the more general resource allocation issue of whether a leaner and more efficient public sector could be achieved through greater conformity with the constitutional principle of subsidiarity, whereby public spending would be more closely matched with state and local tax responsibilities. In formally assigning tasks to the different levels of government -- the federal government (*Bund*), the states (*Länder*) and the local communities (*Gemeinden*) -- and stipulating budgetary independence of the Bund and the Länder, the German constitution (*Grundgesetz*) broadly follows the subsidiarity principle. However, in practice, taxing powers are largely centralised and there is only limited regional and local fiscal autonomy. The theory of fiscal federalism suggests that more effective resource allocation could be reached if the federation allowed lower levels of governments more responsibility both for decisions as to what goods and services to provide and for the financing of these.

2. This chapter provides an appraisal of the major features of German federal fiscal relations from the viewpoint of public sector efficiency. The outline of the chapter is as follows: the first section highlights the principal features of German federal-state relations and the diffusion of responsibilities

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1. This paper was originally produced for the OECD *Economic Survey of Germany*, which was published in June 1998 under the authority of the Economic and Development Review Committee. The author is economist on the Germany/Austria Desk in the Economics Department. He is indebted to Robert Price (Head of Division) and Grant Kirkpatrick (Head of Desk) for substantial drafting contributions and to Stephen Potter, Val Koromzay, Kathryn Gordon and Deborah Roseveare for valuable comments. Special thanks go to Sylvie Toly for technical support and to Janice Gabela for technical preparation.

among the component governments. The second section assesses the redistributive function of the inter-state financial equalisation system and its inherent disincentive aspects. The following section then considers the implications for the equalisation system which arise with the Stability and Growth Pact, in the context of the need to cap borrowing at federal and state level. Finally, the chapter considers more fundamental questions related to the allocation of spending and taxing powers over the various levels of government, where greater autonomy of sub-central layers of government and a closer matching of tax and spending responsibilities may be called for if the objectives of a smaller and more efficient public sector are to be achieved.

### **Inter-governmental relations: consensus and co-ordination**

3. An important motivation behind Germany's constitution was to provide a federal framework in which the states would enjoy a high degree of autonomy, but the historical outcome has been rather different. In most areas the primacy attached to federal legislation leaves very little room for individual state autonomy. But at the same time the states are collectively allowed an important say in federal decision-making, so that German federal relations are based upon inter-governmental co-operation and the co-ordination of fiscal policies. Policy co-ordination between the levels of government is institutionalised in a number of councils, the most important of which is the Financial Planning Council (*Finanzplanungsrat*), comprising the ministers of finance of the federation and the Länder as well as the Federal Minister of Economics and representatives of the communities. The council exchanges assumptions about the economic and financial development and makes recommendations on the co-ordination of budgets and financial plans of the federal, Länder, and communal governments. However, since the constitution stipulates that all territorial authorities are autonomous with respect to their budgets, the council cannot make any binding decisions.

4. The states are also directly involved in the federal legislative process. The Länder are represented in the second chamber of parliament, the *Bundesrat*, where they each have between three and six votes depending on their size. Direct involvement of the states in the federal legislative process contrasts with other federal countries, such as the United States where the Senate typically does not represent state governments as such. Federal laws which affect directly the Länder financially or administratively require the consent of the *Bundesrat* and the trend toward tax sharing has *de facto* widened their right to consent, which now covers some 60 per cent of federal legislation. The *Bundesrat* may also veto legislation which does not require its approval, but such vetoes can be rejected by a majority of all members of the first chamber of parliament (*Bundestag*). The *Bundesrat* may also submit its own bills to the *Bundestag*.

5. The strong centralisation of the German federal fiscal system is thus characterised, *de facto*, by institutions which promote co-operation and consensus. While in the German constitution, co-operation and independence receive equal emphasis, in practice the area of state autonomy remains highly restricted, largely based on the constitutional principle of creating a uniformity of living conditions throughout the country. This has led to complex inter-governmental arrangements, which foster co-ordination but benefit neither from the discretionary flexibility of unitary states, nor from the potential for efficient resource allocation which is usually thought to come from devolved public-sector decision making.

### ***Expenditure responsibilities overlap***

6. Public expenditure is characterised by shared responsibilities for implementation and finance which make for a system of quite complex overlapping competencies. The federal government is in principle responsible for matters considered to be of relevance for the whole country, as well as for the redistribution of income across the federation. Since the writing of the constitution in 1949, justification of

federal legislation in these terms has become quite broad. The tasks comprise, *inter alia*, federal public transport, formulation of economic policy, supervision of competition policy, and transfers to the social security system. The Länder are responsible for all tasks which are not explicitly attributed to the federal government. Major competencies comprise the education and university systems, health services and the provision of law and order. The communities are attributed the right to control local matters such as road construction, school building, health services, public transport and energy supply, as well as the provision of social assistance. The functional segregation of responsibilities is not as strict as the above dichotomy suggests, however, and the system is now characterised by overlapping responsibilities. For example, all three territorial authorities and the social security system perform tasks with respect to health care: the Bund sets the pertinent legal conditions, the statutory health funds finance operating costs for hospitals, the Länder finance hospital investment and regulate hospital capacity, and the communities provide local health care services. Investment in transport and aid to enterprises are other examples where spending involves all three layers of government. Administrative responsibilities belong to a considerable degree to the Länder<sup>2</sup>.

7. Shared responsibilities also involve co-financing between the federal and the state governments. The constitution recognises three types of Länder expenditures which can be co-financed by the Bund. For each of them, the Bund takes on between 50 and 60 per cent of the associated costs (Table 1). First,

Table 1. **Länder expenditures co-financed by the federal government**

	Joint Fiscal Tasks	Financial Aid for Investment	Disbursement of Funds
<b>Major projects or disbursements</b>	University construction Regional economic structure  Agricultural structure and coast protection	Communal road construction Construction of social housing Modernisation of residential buildings Flood protection Energy provision and saving	Education benefits Residence benefits
<b>Financial contribution of the federal government</b>			
Share	50 per cent or more	50 per cent or more	50 per cent or more
Volume in 1990			
Billion DM	8.3	7.6	13.8
(Per cent of GDP)	(0.3)	(0.3)	(0.6)
Volume in 1997			
Billion DM	13.0	13.3	16.0
(Per cent of GDP)	(0.4)	(0.4)	(0.4)
<i>of which:</i>			
To the new Länder	4.8	7.3	2.4

Source: Ministry of Finance; OECD.

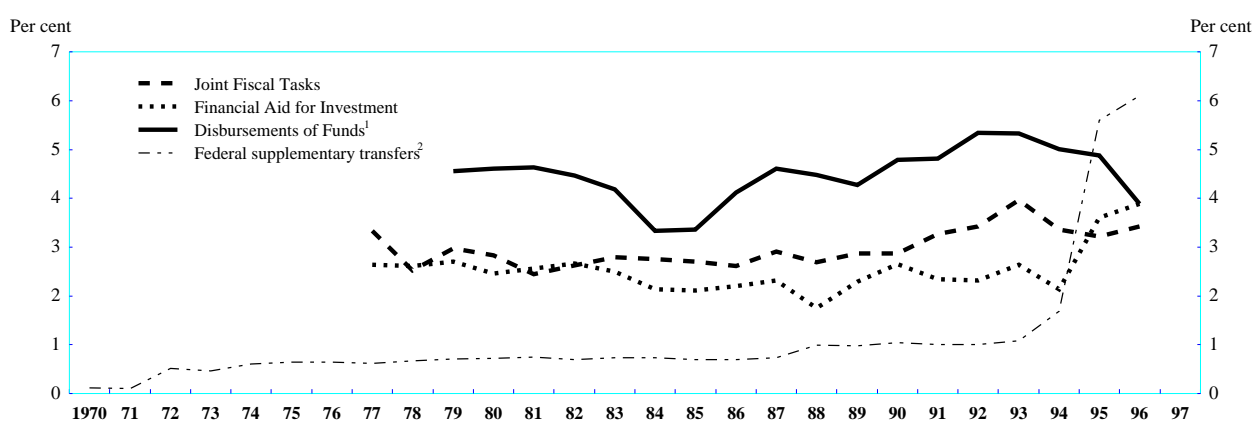
“Joint Fiscal Tasks” (*Gemeinschaftsaufgaben*) comprise those projects which are jointly planned by the Bund and the Länder, covering the fields “investment in universities”, “improvement of the regional economic structure”, and “improvement of the structure of the agricultural sector and coast protection”. Decisions about co-financing and project planning are taken jointly with equal voting rights for the Bund and the Länder (combined). Co-funding the programme “improvement of the regional economic structure” is conditional on the recipient state having financing capacity below the federal average or its economy being subject to structural change such that disadvantages for it could be expected. Second, Financial Aid (*Finanzhilfen*) can be granted for major Länder or communal investments for the purpose of averting

2. The share of the federal government in overall general government spending belongs to the lowest in the OECD (some 20 per cent, national accounts terms). Bund, Länder and communities account for 11.5, 52.5 and 36 per cent of the territorial authorities’ employment respectively.

economic disequilibrium, equalising differing economic capacities or promoting growth. Finally, grants for “Disbursement of Funds” (*Geldleistungsgesetze*) support social transfers by the Länder and may be implemented at the request of the federation.

8. Inter-governmental planning and co-financing of public activities have increased in importance. Mixed financing and co-determination between levels of government was formally introduced into the constitution in 1969. Between the end of the 1970s and reunification federal outlays devoted to cofinancing of Länder tasks -- Joint Fiscal Tasks, transfer for Länder Disbursements and Financial Aid for Investment -- increased by some 15 per cent in real terms. Measured as a share of total federal revenues federal support for Disbursements and Joint Fiscal Tasks increased over the 1980s (the former after a significant drop in the first half of the decade) while Financial Aid for Investment declined only a little. Federal grants combined surged after reunification, mainly to aid investment in the new Länder (Figure 1). In addition, supplementary federal transfers (*Bundesergänzungszuweisungen*), which are not earmarked, increased slowly but steadily as a percentage of federal government revenues after the beginning of the 1970s and surged after unification.

Figure 1. **Federal co-financing of sub-central fiscal projects**  
Grants by federal government as per cent of total federal receipts



1. The drop in 1996 is dominated by the restructuring of child benefits for whose provision the Länder are no longer responsible.
2. These are not earmarked. Between 1990 and 1994 additional federal transfers were channelled through the German Unity Funds to the new Länder, but are not included here.

Source: Ministry of Finance; OECD.



***Increasing reliance on tax sharing***

9. The federal revenue system has relied increasingly on tax sharing (Box), with the fraction of own taxes, accruing exclusively to a particular tier of government, declining at each level (Table 2)<sup>3</sup>. Given that the percentage shares in VAT receipts of Bund and Länder can be adjusted by simple legislation, the vertical distribution of VAT revenue has quite often been adjusted; rising spending pressure, in particular due to reunification, and transfers to the new states by the old Länder led to the Länder share in VAT receipts being raised to its present level<sup>4</sup>. The importance of tax sharing will increase further with the termination of the local business capital tax in 1998 since VAT sharing is being extended to the communities as compensation (2.2 per cent share in 1998).

**Box: Tax sharing and revenue equalisation in Germany**

The German system of tax revenue allocation comprises two distinct processes: the first involves the division of shared taxes between the territorial authorities -- the Bund, sixteen Länder and the communities -- according to agreed criteria, while the second adjusts the distribution of tax revenues to achieve distributional goals.

***The primary system of tax sharing***

About three quarters of overall tax revenues in Germany are shared vertically between different layers of government (shared taxes), the remainder accruing to one particular tier only (own taxes). Shared taxes mainly comprise VAT and income taxes (personal and corporate), which account for 30 and 40 per cent of total tax revenues, respectively. Both are subject to federal legislation, but tax collection is administered by the Länder. The percentage shares of the Länder and the federal government in income and corporate tax revenue are stipulated in the constitution such that any reallocation requires a constitutional change. For VAT, on the other hand, the percentage shares of the Bund and the Länder can be adjusted by simple legislation, subject to the consent of the Länder in the Bundesrat. According to the constitution, VAT revenues should be allocated such that the coverage of expenditures by revenues be even between the Bund and the Länder. Accordingly, the vertical allocation of VAT receipts has been regarded as the main flexible element in the overall distribution of tax revenues between the Bund and the Länder. For 1998, 3.64 per cent of VAT receipts have been assigned to the Bund for transfers to the pension system. The communities

3. Income tax sharing between the Bund and the Länder was introduced in 1955. Up to that time income tax revenue was assigned to the Länder although in exceptional circumstances the Bund could also participate. The rebalancing of revenues was largely motivated by the desire to mobilise federal funds for the purpose of financing Germany's reconstruction. In 1970, sharing of income tax revenues was extended to the communities (15 per cent share), in exchange for a participation of the Bund and the Länder in the communal business trade and capital taxes. Simultaneously, the Länder obtained a 30 per cent share in the federal turnover tax. This restructuring was largely motivated by the desire to smooth the cyclical sensitivity of their tax revenues. Subsequent extensions of tax sharing were largely driven by Länder demands to compensate them for rising spending obligations.

4. Between 1970 and 1989 the Bund and the Länder received equal shares of the local business tax although the shares of each have fallen from 20.3 per cent to 7.2 per cent. After reunification the western communities contributed to transfers to the eastern Länder by increasing the business tax share of the Länder. As a result, the Länder's share in the business tax in 1996 totalled 18.1 per cent, and the Bund's share dropped to 5.0 per cent. Also, since 1996 the Bund's mineral oil tax, accounting for 9 per cent of overall tax receipts, is shared with the Länder (18.2 per cent share). The share of the mineral oil tax serves to finance Länder investment in railway infrastructure.

receive 2.2 per cent of the remaining VAT revenues. Of the remainder, 50.5 per cent accrues to the Bund and 49.5 per cent to the Länder. With respect to income tax receipts (net of the solidarity tax surcharge) 42.5 per cent accrue to the Bund and the Länder respectively and the remaining 15 per cent accrue to the communities. Other shared taxes are the business trade tax and the mineral oil tax. Major own taxes are tolls, the insurance tax, the tobacco tax and the “solidarity” income tax surcharge accruing to the Bund, the inheritance and the automobile tax accruing to the states, and the real estate tax and consumers taxes accruing to the communities.

Horizontal apportioning of income-tax revenues between states proceeds according to the residence principle, i.e. income tax accrues to the tax-payer’s resident state<sup>1</sup>. Corporate tax revenue is divided among states by a formula which is based on plant location, taking into consideration that companies may have branches in different states. Another difficult horizontal assignment problem concerns VAT revenue. Neither the source nor the principal residence can be applied in a meaningful way. As a pragmatic solution, VAT revenue is simply distributed to states on a per capita base.

### ***The secondary system of revenue equalisation***

This primary system of tax revenue allocation is transformed by a second system which redistributes revenues between the territories based on the constitutional objective to create broadly equal living conditions across regions. Länder which are financially weaker in terms of their primary tax receipts receive both horizontal transfers from financially stronger Länder and vertical transfers from the federal government to enable them to finance their fiscal tasks. There is a similar redistribution of revenues within the Länder for financially weaker communities.

Financial equalisation of Länder tax receipts is conditional on the primary distribution of tax revenues over the Länder and communities and proceeds in three stages, the first two of which are horizontal while the third involves vertical transfers from the Bund. At the first stage (*Umsatzsteuervorwegausgleich*) up to 25 per cent of the value-added tax receipts of the Länder is redistributed in favour of Länder which are endowed with relatively low-tax revenues after the primary tax allocation. At present, redistribution at this stage exclusively benefits the new Länder (Table 3, column 1). Equalisation at the second stage (*Länderfinanzausgleich im engeren Sinne*) is conditional on the Länder’s tax revenue endowment after stage one, including half of its local communities’ tax receipts. For each Land the resulting finance endowment (*Finanzkraft*) is compared with its “financial needs” (*Finanzbedarf*). Unlike in many other federal systems, the concept of “need” is not related to expenditures but simply refers to per capita tax income for the whole country. However, expenditure needs are taken into account to the extent that effective population is regarded as 35 per cent higher than actual population for the three city states: Hamburg, Bremen and Berlin. Revenues are redistributed from states whose financial endowments exceed their “financial needs” (or reference income level) to the states for which the opposite is true (Table 3, column 2). For contributing states, the surplus of financial endowment over financial needs is transferred to the receiving states at a progressive rate which increases up to 80 per cent. At this stage financially-weaker Länder reach 95 per cent of their “financial needs”.

At the third stage of the equalisation system, the financial endowment of the financially weaker Länder is lifted to at least 99.5 per cent of their “financial needs” by supplementary grants of the federal government (*Fehlbetrags-Bundesergänzungszuweisungen*) (Table 3, column 3). In addition, the Bund makes supplementary grants for special needs (*Sonderbedarfs-Bundesergänzungszuweisungen*) for the purpose of compensating some states for special burdens (Table 3, column 4). Special supplementary grants benefit in the first place the new Länder, which obtain a lump-sum transfer of DM 14 billion per year until 2004<sup>2</sup>. Special supplementary grants are also paid to small Länder to compensate them for higher administrative costs and to western Länder as a compensation for higher fiscal burdens due to reunification (digressive over ten years). Two Länder obtain special supplementary transfers as federal aid for their debt servicing obligations.

Although the equalisation system was redesigned to include the new Länder from 1995 onwards, its features changed little from the former system, which remained in force until 1994 for the old Länder. The restructuring was necessary because inclusion of the eastern states into the old system would have implied substantial transfers from the western to the eastern Länder and an effective elimination of transfers to western states. As a result, the volume of supplementary grants was substantially increased. In the interim period between 1990 and 1995, funds were redistributed to the new states mainly via the German Unity Fund, which was financed via contributions of the Bund (31 per cent) and the old Länder (10 per cent) as well as by borrowing on the capital market (59 per cent). Between 1990 and 1994 the German Unity Fund redistributed DM 160.7 billion to the new Länder (on average about 1 per cent of GDP annually).

1. This rule has been criticised by the city states, Berlin, Bremen and Hamburg, which lose tax revenue from workers living in neighbouring states.
2. The level of the special supplementary transfers to the new Länder will be re-examined in 1999.

10. Since the beginning of the 1960s the Länder have received an increasing allocation of the territorial authorities' total tax receipts, raising their portion by almost 10 percentage points to some 40 per cent. While the portion allocated to the communities fluctuated at around 13 per cent, that received by the Bund declined accordingly to some 48 per cent (Table 2).

Table 2. **Tax accruals by layer of government**  
Per cent of respective total

	1951	1960	1970	1980	1989	1996
<b>Federal government<sup>1</sup></b>						
Portion of total tax revenues	58.0	54.9	54.8	50.1	48.7	47.8
<i>of which:</i>						
Unshared federal taxes	89.0	76.6	32.8	23.4	24.0	16.1
Taxes shared with other layer of government	11.0	23.4	67.2	76.6	76.0	83.9 <sup>2</sup>
<b>Länder</b>						
Portion of total tax revenues	28.0	30.6	33.1	35.4	36.9	39.8
<i>of which:</i>						
Unshared Länder taxes	17.0	22.2	18.9	12.8	12.8	12.7
Taxes shared with other layer of government	83.0	77.8	81.1	87.2	87.2	87.3 <sup>2</sup>
<b>Communities</b>						
Portion of total tax revenues	14.0	14.5	12.1	14.5	14.4	12.4
<i>of which:</i>						
Unshared communal taxes	100.0	100.0	26.8	16.4	12.9	17.2
Taxes shared with other layer of government	0.0	0.0	73.2	83.6	87.1	82.8 <sup>3</sup>
<b>Total</b>	100.0	100.0	100.0	100.0	100.0	100.0

1. Excluding taxes which accrue to the EU.

2. Personal income tax including wage tax, corporate income tax, source tax on interest, VAT, business tax, mineral oil tax.

3. Personal income tax including wage tax, source tax on interest, business tax.

Source: Ministry of Finance; OECD.

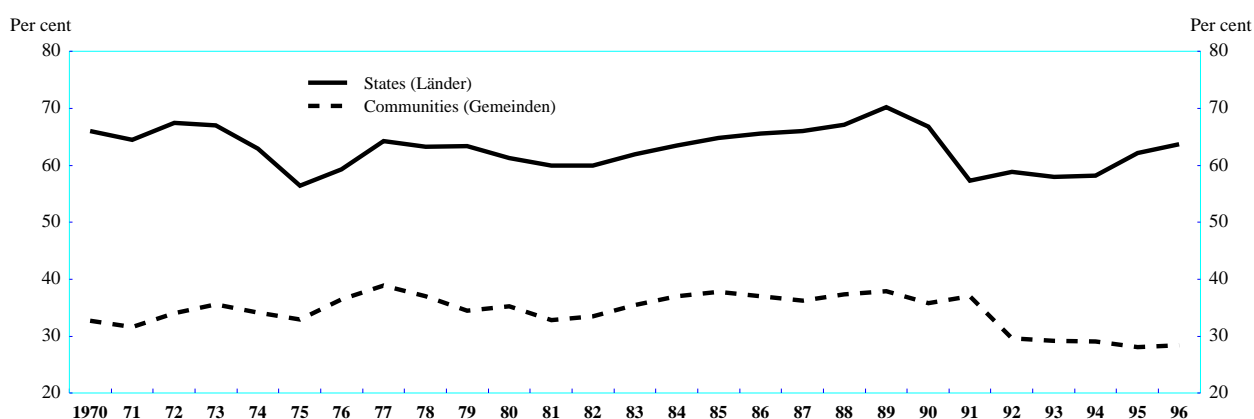
### **... and declining tax autonomy**

11. In line with the rising importance of tax sharing, the degree of tax autonomy of the sub-central levels of government, defined as the right to vary either tax bases or tax rates, has declined. The most

fundamental change occurred in 1955, when the Bund took over the legislative responsibility for the income tax, and the recent abolition of the local business capital tax has increased centralisation still further<sup>5</sup>. Sub-central governments have relatively little tax autonomy. Even for unshared taxes, the right to revenues and the right to change the tax legislation often diverge: major Länder taxes are determined at the federal level and major local taxes at the Länder level. A notable exception is the local business tax (*Gewerbesteuer*) whose rates are determined by the communities within certain limits. The business tax accounts for some 40 per cent of the communal tax revenues after tax sharing. Legislation with respect to the income and the value added taxes rests exclusively at the federal level. By contrast, in several OECD countries regional or local governments have discretionary power over income and/or value added or sales taxes which are the most important taxes in the OECD. This applies for the United States, Canada, Denmark, Switzerland, Finland, and Sweden.

12. Up to unification the Länder on average were able to finance about 65 per cent of their total spending by tax revenues (own and shared), but this changed rapidly after reunification (Figure 2): the

Figure 2. Share of state and community spending financed by taxes<sup>1</sup>



1. Taxes as a percentage of total spending according to finance statistics. Taxes of Länder are net of federal supplementary transfers (*Bundesergänzungszuweisungen*).

Source: Ministry of Finance, *Finanzbericht*, various issues; OECD.

low taxing capacity of the new Länder and weak tax revenues in the wake of the economic downswing in 1993 have led to a decline in the tax-to-spending ratio to below 60 per cent, though with some increase more recently<sup>6</sup>. The communities finance around 35 per cent of their total spending by tax receipts, with the degree of tax sufficiency slightly increasing until the beginning of the 1990s. At present, tax receipts cover less than 30 per cent of total spending<sup>7</sup>.

<sup>5</sup>. See *OECD Economic Survey of Germany*, 1996. See also Blankart, Charles, "Politische Ökonomie der Zentralisierung der Staatstätigkeit", Humboldt-Universität zu Berlin, *Economic Series Discussion Paper 108*, 1998.

<sup>6</sup>. About four-fifths of the Länder's total revenues comprise taxes or income from fees, business activities or the sale of assets. The remainder is made up of transfers from other levels of government.

<sup>7</sup>. About two-thirds of the communities' total revenues comprise taxes or income from fees, business activities or the sale of assets. The remainder is made up of transfers from the Länder and the Bund.

## The fiscal equalisation system

### *Revenues are equalised across states*

13. The primary system of revenue sharing described in the Box above is transformed by a secondary system based on the principle of burden sharing. Indeed, the constitutional principle that each layer of government has to bear the costs for the fulfilment of its public tasks has, in fact, been supplanted by the principle of revenue equalisation arising from the constitutional objective to broadly equalise living conditions. Therefore, financially weak Länder receive transfers from wealthier states (horizontal transfers) and transfers from the federal government (vertical transfers) to enable them to finance their responsibilities (Box). There is a similar redistribution of revenues within the Länder to financially weaker communities. While the Länder equalisation system is fixed by federal law, there are different arrangements for the equalisation systems at the communal level which are governed by legislation of the respective Länder. This section focuses on the design of the equalisation system for the Länder and its associated incentive structure<sup>8</sup>.

14. The fiscal equalisation system yields a substantial redistribution of income in favour of the financially weaker Länder (Table 3 columns 5, 6, 7 and 8). In 1996, the per capita tax revenues of the poorest Land, including communities, amounted to 80.1 per cent of the average prior to redistribution; after redistribution and supplementary transfers it exceeded the average by 8.7 per cent. The coefficient of variation for per capita revenues even slightly increases as a result of the process. On the other hand, taking a long term perspective the fiscal equalisation system appears to have had little success in achieving convergence of the Länder's economic performance. Between 1970 and the beginning of transitory equalisation arrangements in 1990 only one state ceased to be a recipient. More importantly, among the old Länder, the dispersion of real GDP per capita has declined little, the standard deviation remaining at around one fourth of the mean over the last 27 years (Figure 3). Similarly, over the same time span, the dispersion of unemployment rates remained roughly constant. With active labour-market measures, like training and job-provision programmes, netted out, the disparities in states' unemployment are even higher. While this development also reflects the lack of regional differentiation in collective bargaining outcomes, it also indicates that there was little or no convergence in the Länder's employment capacity.

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8. For features of communal equalisation systems see Parsche, R., and M. Steinherr, "Der kommunale Finanzausgleich des Landes Nordrhein Westfalen", *ifo Studien zur Finanzpolitik*, vol. 59, München, 1995; Steinherr, M., "Das Schlüsselzuweisungsproblem im kommunalen Finanzausgleich des Freistaates Sachsen", *ifo Studien zur Finanzpolitik*, vol. 63, München, 1997; Steinherr, M., R. Parsche and R. Koll, "Der Ausgleich zwischen Finanzbedarf und Finanzkraft im kommunalen Finanzausgleich des Landes Rheinland-Pfalz", *ifo Studien zur Finanzpolitik*, vol. 66, München, 1998.

Table 3 **Redistribution of tax revenues in the Länder financial equalisation system**  
1996

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
	VAT equalisation	Horizontal state equalisation	Federal supplementary transfers	Federal special supplementary transfers	Taxes prior to redistribution <sup>1</sup>	Revenues after redistribution <sup>2</sup>	Taxes per capita prior to redistribution	Revenues per capita after redistribution
	DM million				DM			
North Rhine-Westphalia	-3 669	-3 125	0	0	92 115	85 321	5 132.4	4 753
Bavaria	-2 462	-2 862	0	0	61 416	56 092	5 099.5	4 657
Baden-Württemberg	-2 119	-2 521	0	0	53 082	48 442	5 116.6	4 669
Lower Saxony	-1 597	+553	830	456	35 225	35 467	4 507.5	4 538
Hesse	-1 233	-3 240	0	0	33 769	29 296	5 602.5	4 860
Saxony	+4 186	+1 965	846	3 658	17 747	28 402	3 904.1	6 248
Rhineland-Palatinate	-816	+231	352	625	18 259	18 651	4 564.2	4 662
Saxony-Anhalt	+2 821	+1 241	506	2 372	10 517	17 457	3 861.4	6 409
Schleswig-Holstein	-559	+16	24	368	12 733	12 582	4 643.2	4 588
Thuringia	+2 635	+1 127	462	2 172	9 367	15 763	3 760.5	6 327
Brandenburg	+2 194	+1 035	471	2 149	10 125	15 974	3 963.9	6 253
Mecklenburg-Western Pomerania	+1 820	+856	337	1 643	6 989	11 645	3 845.9	6 408
Saarland	-1	+234	201	1 825	4 655	6 914	4 293.1	6 376
Berlin	-710	+4 336	859	2 881	15 876	23 242	4 589.9	6 719
Hamburg	-350	-482	0	0	12 126	11 294	7 099.5	6 612
Bremen	-139	+635	120	1 998	3 502	6 116	5 166.5	9 023
Total	±13 656	±12 229	5 008	20 148	397 503	422 658	..	..
Average	0	0	313	1 259	24 844	26 416	4 696.9	5 819
Coefficient of variation	..	..	..	..	..	..	0.18	0.21

1. The figures include the partial reallocation of mineral oil tax revenues from the Bund to the Länder which was introduced in 1996.

2. (6) = (5) + (1) + (2) + (3) + (4).

Source: Ministry of Finance; OECD.

### *Disincentive effects of high marginal effective tax rates on the Länder*

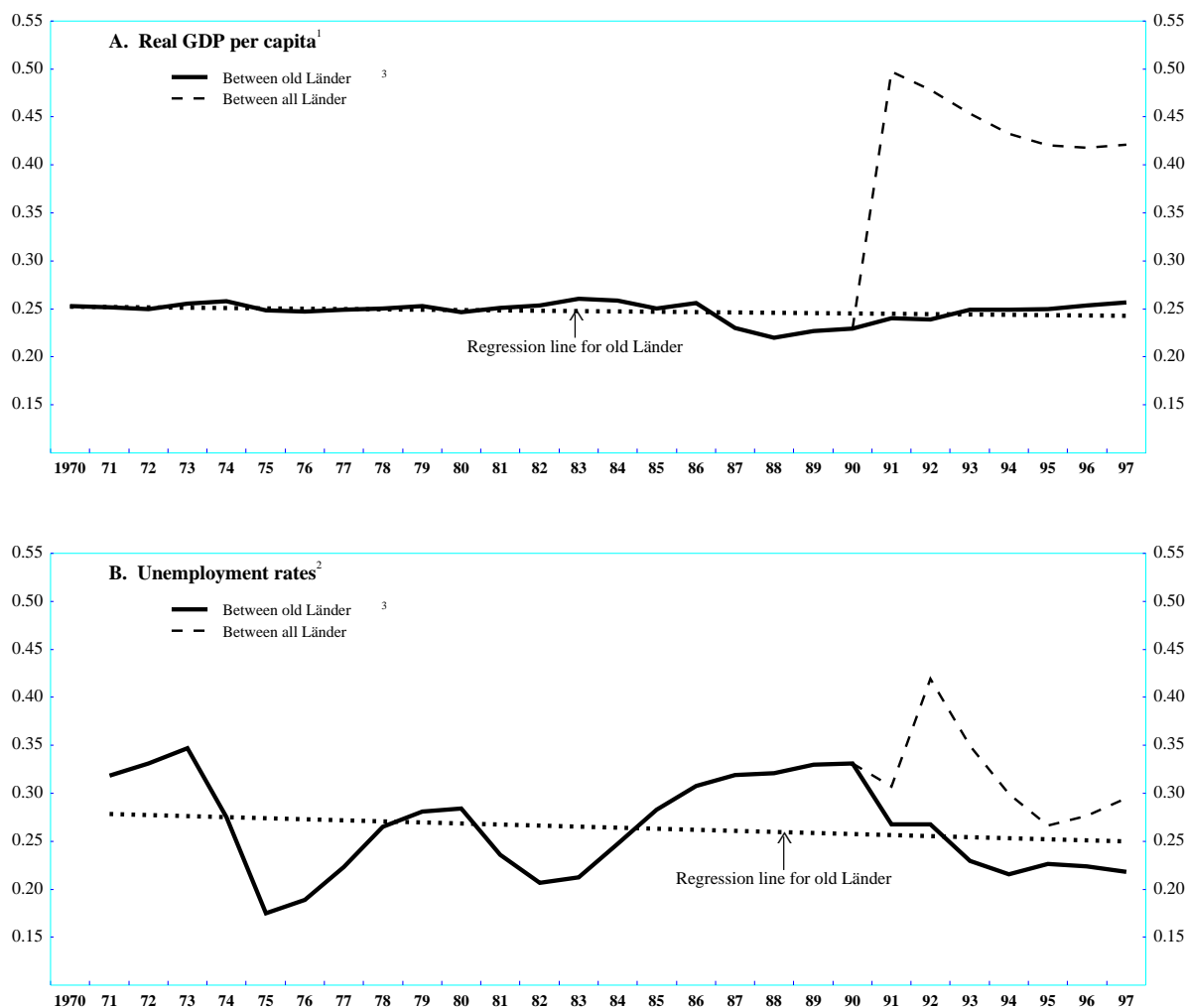
15. In contrast to other OECD countries, the inter-state equalisation component has a high weight in the overall redistribution, so that marginal increases in tax revenue accrue only partially to the states involved and are automatically redistributed, raising questions about the structure of incentives facing policy-makers and the electorate. The same problem is repeated at lower levels with the communal redistribution system, which equalises income of the communities within each state. With per capita revenue levels more equalised, the system has been repeatedly criticised for providing disincentives for the Länder to raise their own economic performance and tax bases.

16. By design, the financial equalisation system (in a more narrow sense, net of federal special-needs supplementary transfers) should leave the financial ranking of the contributors unchanged, but taking special transfers into consideration it changes the ranking in terms of per capita revenues<sup>9</sup>. This aspect has come in for some criticism. But, disincentive effects become apparent by considering the effective outflow of additional tax revenues generated by the Länder which is implied by the rules of tax sharing and subsequent redistribution. For individual states, an additional DM 1 million in income tax receipts -- either personal or corporate -- generates only between DM 80 000 and DM 290 000 in extra tax income,

9. For example, the Saarland which has the lowest per capita tax receipts among the western Länder prior to redistribution ranks third among the western states after redistribution (Table 3).

depending on the Land (Figure 4)<sup>10</sup>. The remainder is allocated to both the Bund and the other Länder. For wealthy states the equalisation system transfers part of the additional revenues after tax sharing to poorer states. However, for less wealthy states, including those in eastern Germany, additional revenues after tax sharing reduce the eligibility for equalising vertical and horizontal transfers. With effective taxation of additional income tax revenues amounting to between 70 and 90 per cent, the system produces few incentives for the Länder to create conditions which attract companies and which increase their GDP.

Figure 3. **Variability of per capita income and unemployment between Länder**  
Coefficient of variation



1. Population measures end of year. For 1997 population as 31 June 1997.

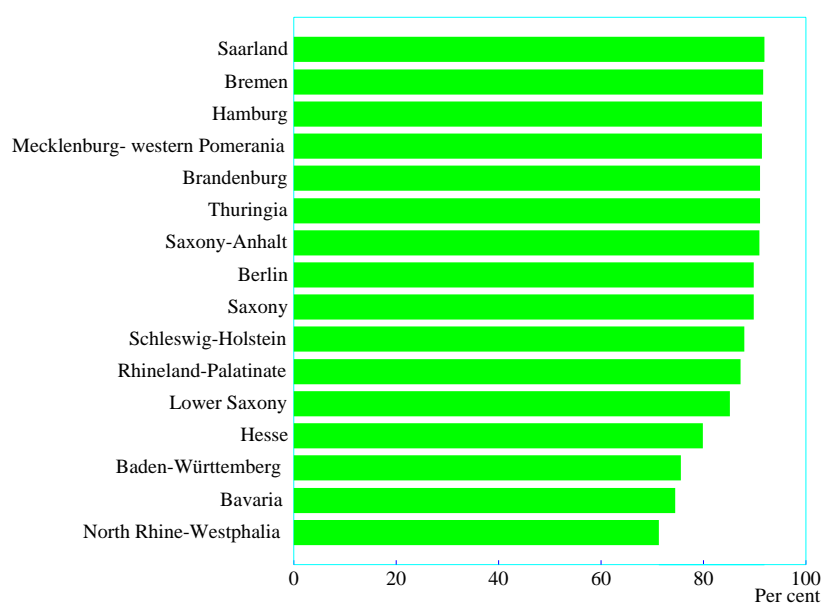
2. Unemployment as a percentage of dependent employment.

3. Excluding west Berlin from 1991 onwards.

Source: Arbeitskreis "Volkswirtschaftliche Gesamtrechnungen der Länder"; Statistisches Bundesamt; OECD.

<sup>10</sup>. See Huber, Bernd and Karl Lichtblau "Konfiskatorischer Finanzausgleich verlangt eine Reform", *Wirtschaftsdienst* 3/1998. For the Länder's own taxes (e.g. inheritance tax) the authors compute marginal effective tax rates of between 58 per cent and 99 per cent.

Figure 4. **Outflow of Länder tax revenues due to interaction of tax-sharing and financial equalisation<sup>1</sup>**  
Per cent



1. In 1996. Percentage outflow arising from an assumed DM 1 million increase in the Land's income tax receipts.  
*Source:* Huber B., and K. Lichtblau, mimeo, "Germany's Federal Financial System -- An Analysis and a Reform Proposal", Munich, 1998.

17. Low rates of tax auditing by the Länder may also be due to the fact that although they bear the cost of tax administration, only a small fraction of additional tax revenues accrues to them, so that it hardly pays from the individual Länder perspective to strengthen audits. A recent study evaluating auditing statistics concluded that the average time between company tax audits amounted to between seven and twelve and a half years, depending on the state. For small enterprises, the average period between audits extends up to several decades<sup>11</sup>. A low incidence of tax auditing creates opportunities for enterprises to reduce their effective tax burden. Indeed, "tax competition", driven by the political incentive to seek to increase employment, could take the form of differential state interpretation of the provisions of federal tax law.

11. The study was conducted by the Arbeiterkammer Bremen. Quoted in *Süddeutsche Zeitung*, 9 March 1998.



***Reform requirements: ensuring support while reducing disincentives***

18. Given that the existing system of financial equalisation appears to discourage the development of taxable activity, while not helping to unwind existing disparities in economic capacity, the aim of equalising living conditions among the states appears to have quite harmful economic side-effects. Conversely, a system which reduced the marginal taxation of Länder revenues significantly and increased the transparency of the system would be likely to improve public sector efficiency without necessarily compromising the basic aim of the fiscal equalisation process. Indeed, there may be areas where a more incentive-based system could be more effective in achieving this objective than is currently the case. The latter aspect is of particular importance with respect to the new Länder which command a revenues base which still falls dramatically short of the taxing capacity of the western Länder (Figure 5). In view of the fact that the financial equalisation system in the narrower sense (excluding special needs and supplementary grants) involves transfers accounting for less than 10 per cent of the Länders' and communities' tax revenues, the reform task would appear to be a manageable one.

19. One such a reform, which is consistent with ambitious redistribution objectives, could be realised by implementing a two-stage system which allocates lump-sum payments, fixed over a multi-annual period, to poorer states at stage one and redistributes taxes between states at the second stage conditional on their financial capacity as it prevails after stage one. In such a system, lump-sum transfers to particular states would achieve a minimum endowment of the Länders' financial resources over a multi-annual horizon in accordance with political objectives. After the reference period has passed, the allocation of lump-sum transfers would be reviewed and new allocations decided. In principle, the transfers at the first stage could be financed by contributions of both the Bund and the Länder. Given that the financial endowment of the poor Länder would have been already raised at the lump-sum stage, the transfer rate for redistributing revenues between the Länder at the second stage could be reduced to a fraction of the rates prevailing in the present system. For transparency and administrative simplicity, a single linear transfer rate would need to be applied and the entire equalisation system should be confined to two stages only. It is important to note that such a system could be introduced in a way that leaves the financial endowment of the parties involved unaffected in the transition phase. Thereafter, all parties would gain from improved efficiency of the system<sup>12</sup>.

20. Fixing lump-sum payments over a multi-annual horizon is a necessary condition for reducing the effective marginal taxation of the Länders' tax revenues in the redistribution process, which in turn generates incentives for the Länder to strengthen their own revenue base. If instead payments at stage one were frequently revised in accordance with the evolution of the Länders' revenue raising capacity, the equalisation process would effectively produce disincentives similar to those of the present system.

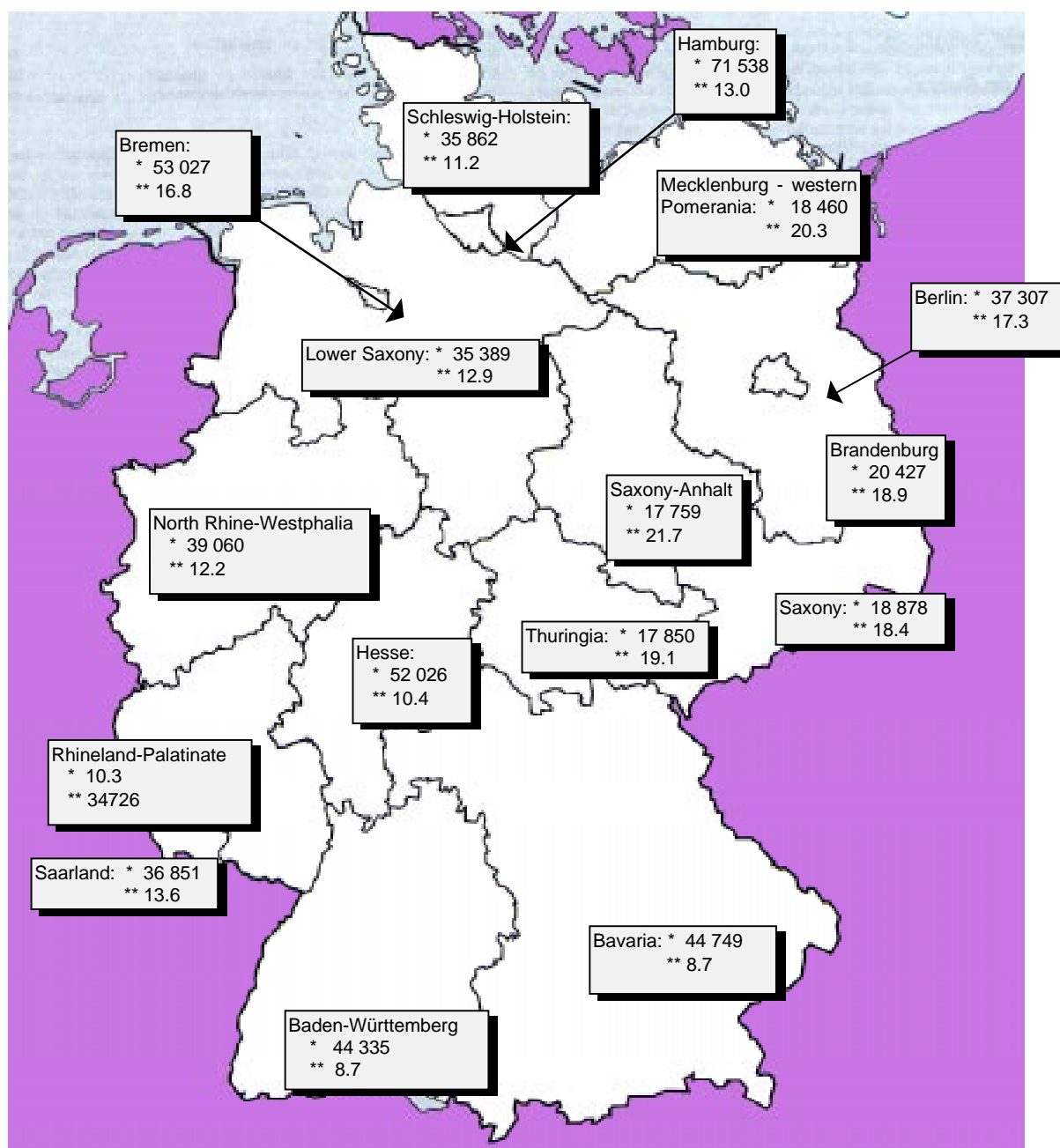
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<sup>12</sup>. Redesigning the <sup>financial</sup> equalisation system along these lines has been suggested by Huber and Lichtblau, *op. cit.* The authors show, based on official tax receipt estimates, that under their reform proposal -- neglecting any efficiency gains -- the new system would slightly benefit the eastern states in the medium term. Similar proposals, which do not explicitly recognise the important role of lump-sum payments to reduce the implicit marginal taxation of Länder revenues, have been made by the Council of Economic Advisors, *Jahresgutachten* 1991/92, and by Hüther M., "Reform des Finanzausgleichs: Handlungsbedarf und Lösungsvorschläge", *Wirtschaftsdienst* 1/1993.

Figure 5. Real per capita income and unemployment in the Länder<sup>1</sup>

\* Real GDP per capita, DM

\*\* Unemployment as a per cent of dependent employment



1. In 1997.

Source: Arbeitskreis "Volkswirtschaftliche Gesamtrechnungen der Länder"; Statistisches Bundesamt; OECD.

### **Implementing the Stability and Growth Pact: the need for a domestic equivalent**

21. The issue of fiscal incentives and Länder responsibilities overlaps with the debate on the implementation of the Stability and Growth Pact. Germany is obliged under the terms of the Stability and Growth Pact to observe a general government deficit limit and to accept sanctions including fines in the event of non-compliance, and this has created a need to reconsider aspects of the current federal system. Arguing that under present conditions the Länder could run excessive deficits at the expense of the Bund which would have to bear the fines under EU regulation, the government has proposed to determine legally binding allocations of the Maastricht deficit limit both vertically between the Bund and the states, including the social security system, and horizontally across the Länder. Such budget caps would only apply in the event of an excessive budget deficit for Germany as defined in the Maastricht treaty. It is proposed that violations of deficit limits would determine the allocation of EU fines among Bund and Länder. The emerging debate has concerned questions regarding the extent to which binding deficit allocations are required; what fraction of the total deficit should be allocated to the Bund and the states; how allowances should be shared between the Länder, and to what extent fines should be borne by governments which exceed the allowance. Most fundamentally, the issue of penalising individual Länder stands in potential contradiction to the whole principle of fiscal equalisation as presently set up and argues for the introduction of an incentive system which allows a certain amount of extra state budgetary autonomy. This section considers important aspects of the debate.

22. According to <sup>the</sup> constitution deficits of the federal government must not exceed federal investment spending. This “golden rule” is also contained in some Länder constitutions. While the purpose of the rule is to prevent deficit spending which is not considered to be economically useful, it is not designed as an instrument to secure deficit limits in absolute terms. In contrast, allocating deficit allowances to the different layers of government appears to be the most suitable way to translate the requirements of the Maastricht treaty into an internal stability arrangement<sup>13</sup>.

23. In principle, supplementing the Maastricht provisions by internal arrangements would also be beneficial with respect to the stabilisation of output over the business cycle. Since the beginning of the 1980s Germany has not in any major way considered fiscal policy an instrument for counter-cyclical policy. Rather, fiscal consolidation is seen as an important condition for fostering economic growth while the fiscal response to conjunctural fluctuations is largely left to the working of automatic stabilisers. Internal deficit allocations can support this approach: to the extent budget caps for the territorial authorities foster the reduction of the general government structural deficit they simultaneously reduce the risk that the working of automatic stabilisers conflicts with the 3 per cent deficit limit.

24. It is important that internal arrangements do not allow for a loosening of the definition of “excessive deficits” over the provisions of the Maastricht treaty. Negotiability of deficit limits could raise general doubts about how binding the caps would be, and might undermine consolidation efforts<sup>14</sup>. Moreover, agreement between all parties might be difficult to reach, and negotiations could give rise to strategic behaviour which would be counterproductive with respect to fiscal consolidation. Hence, the distribution of deficits should not be negotiable but strictly fixed, taking into consideration the higher

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13. While deficit caps are sensitive with respect to “creative accounting”, arrangements would benefit from rules which have been developed by Eurostat to control this problem.

14. Empirical research for the United States indicates that the degree of fiscal consolidation depends on the stringency of budget caps. States with balanced budget requirements which do not allow carrying-over fiscal deficits from one year to the next have higher surpluses. See Bohn and Inman, “Balanced budget rules and public deficits: evidence from the US states”, *Carnegie-Rochester conference series on public policy* 45, 1996.

cyclical sensitivity of the federal budget. The latter is attributable *inter alia* to the fact that the Bund and the social security system bear the bulk of unemployment related benefits which provide a major element of social and fiscal stabilisation at the Länder level. There are at present two formula being negotiated covering the broad vertical allocation of the deficit limit: one foresees equal deficits for the states and the federal budget including the social security system, while the other, proposed by the states, places the deficit allocation at a ratio of 60/40 in favour of the states.

25. Regarding the allocation of deficit limits between states, financially weaker Länder (especially those in the east) have argued for an allocation in line with past deficits, motivated by the perception that high deficits reflect high financial needs which would not be taken care of adequately by other allocation rules. Indeed, the deficit of the new Länder (financial basis, including the communities and including Berlin) averaged 5.1 per cent of own GDP in 1995 -- far above the limit deficit/GDP ratio for the states as a whole of between 1.5 and 1.8 per cent depending on the vertical allocation rule chosen. Moreover, above average deficits in the east do coincide with higher state investment but also with higher outlays for personnel (Table 4).

Table 4. **Spending and deficits of the Länder**  
1995

	Deficit/GDP <sup>1</sup>	Investment/ GDP	Investment per capita	Spending on personnel/GDP	Spending on personnel/ per capita
	Per cent		DM	Per cent	DM
North Rhine-Westphalia	-1.3	2.4	1 034.8	7.9	3 401.0
Bavaria	-0.9	3.7	1 802.2	7.5	3 643.9
Baden-Württemberg	-1.0	2.7	1 299.0	7.8	3 730.5
Lower Saxony	-1.9	2.9	1 127.0	9.2	3 575.1
Hesse	-1.2	2.1	1 187.7	6.8	3 762.3
Saxony	-2.9	11.8	2 985.4	13.6	3 446.1
Rhineland-Palatinate	-1.6	2.9	1 091.8	8.5	3 251.6
Saxony-Anhalt	-5.5	10.7	2 633.1	15.6	3 817.1
Schleswig-Holstein	-1.5	3.0	1 167.5	9.2	3 625.3
Thuringia	-4.4	10.7	2 595.0	14.7	3 559.1
Brandenburg	-4.5	9.2	2 472.6	13.4	3 600.2
Mecklenburg-Western Pomerania	-5.2	10.9	2 748.4	14.1	3 550.3
Saarland <sup>2</sup>	0.5	2.2	872.7	8.8	3 560.9
Berlin	-7.0	4.6	2 000.6	12.4	5 449.2
Hamburg	-1.2	1.5	1 198.0	6.2	4 876.4
Bremen <sup>2</sup>	0.1	2.2	1 254.4	9.0	5 114.7

1. Balances according to finance statistics, including purely financial transactions (privatisations and credits). Communities are included.

2. Balances of the Saarland and Bremen include transfers from the federal government to be used for debt servicing. Net of these transfers the deficit amounts to -3.2 per cent of GDP for the Saarland and -4.5 per cent of GDP for Bremen.

Source: Central Statistical Office; Ministry of Finance; OECD.

26. Allocating deficit allowances on the basis of past deficits has not been welcomed by low deficit states, which believe that it would effectively imply a punishment for a policy of fiscal consolidation in the past and add to existing disincentives for economical usage of resources. However, although a per capita allocation would be preferable on efficiency grounds, it would imply that the deficits of the new Länder would have to fall significantly, given that the eastern states account for 21½ per cent of the population but account for 35 per cent of the overall Länder deficit in 1997. Hence, to avoid the necessity of strongly curtailing investment outlays, which are necessary to catch up with the western states in terms of infrastructure, a transitory arrangement could be made which allows the new Länder to converge gradually from their past deficit positions to the population-based deficits. Alternatively, the allocation of deficit

allowances could be made on both investment and population shares<sup>15</sup>. To the extent that the above-average investment of the new Länder will level off with their catching up with the west, the two rules should produce similar allocations of allowances in the medium term<sup>16</sup>.

27. According to the government's plans, deficit violations would be sanctioned by allocating the EU fines between the Bund and the Länder. However, for sanctions to be effective, the implied financial burden should not be allowed to trigger burden sharing or equalising transfers from other governments. It is questionable to what degree this condition could be met in Germany in view of the fact that, based on a ruling of the constitutional court, two states are presently receiving federal supplementary transfers for the purpose of supporting their debt servicing. Hence, legal conditions would need to be created which prevent any bailing-out. Similarly, allowing for relaxation of deficit allowances in cases of exceptional interest burdens and budgetary emergencies would run the risk of being counter-productive since it would relieve the pressure for state compliance. Instead, the opportunity should be taken to increase the degree of state accountability in fiscal matters.

### **Matching expenditures and revenues: the case for greater state autonomy**

28. Since fiscal consolidation on all levels of government is fostered by efficient arrangements for spending and financing, increasing state fiscal autonomy would seem to be a key condition for the smooth functioning of an internal stability pact, as well as reducing the inefficiencies inherent in the present redistribution system. At the same time, all levels of government will remain under considerable pressure to improve their efficiency and from this viewpoint reforms would need to aim at establishing a greater degree of congruency between spending and the responsibility for financing by level of government. As noted above, responsibilities are at present diffuse, with co-financing in particular blurring the lines. Clarifying lines of responsibility inevitably raises the question of improving taxing rights for lower levels of government. These questions are taken up in this section<sup>17</sup>.

### ***Co-financing goes too far***

29. Co-financing and co-operation reflect the weight that Germany attaches to realising broadly equal living conditions across the federation, but in practice they probably also provide incentives to expand spending. The economic theory of federal fiscal relations suggests that co-funding is warranted to the extent that externalities exist between governments because leaving the financing exclusively to the

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15. This has been suggested by the Institute for Economic Research Halle which has derived a distribution of admissible deficits based on this rule. See Snelting, M., "Der nationale Stabilitätspakt in einer Europäischen Währungsunion: ein Umsetzungsvorschlag", *Wirtschaft im Wandel 12/1997*.

16. A more radical solution would be to auction deficit rights among the Länder. Under the assumption that deficit rights would be acquired by those states which utilise above-average deficits for financing public investment, the auction principle should again produce deficit allocations which are similar to the population-based rule in the medium term. It is then preferable to implement the latter, allowing for a transitory period which regards past deficits, since it is an open question whether deficit restrictions which are auctionable would be perceived by the Länder to be as binding as fixed rules or whether the risk of overruns would increase. Also, auctions could effectively amount to transfers from the poor states to the rich states.

17. In the present equalisation system the need for transfers is inflated by compensating disadvantages of "smallness" which derive from the fact that the cities Berlin, Hamburg and Bremen constitute states on their own. Territorial reform, which would incorporate these cities into larger states and which would result in the merger of other states, could lead to a substantial increase in public sector efficiency and better utilisation of taxpayers' money but the issues are extremely complex, involving political, social and cultural questions, and are not taken up in this paper.

government which provides the goods could lead to underprovision due to free-riding of consumers in other states. Maintaining and upgrading energy and water supply, coast protection, and the environmental aspects of communal road construction could, for example, be seen as requiring inter-governmental co-operation and funding. Also, since different transport systems at the communal level can imply different environmental burdens (road versus subway), co-financing of environmentally preferable systems by the Bund might be justified<sup>18</sup>. Similarly, participation of the Bund in funding university construction might be justified since universities convey positive externalities to other states which can benefit from the education provided (Table 1). It is nevertheless important to note that the existence of externalities does not in every case require the involvement of the federal government. For example, part of university construction costs could effectively be transferred to the benefiting states by introducing fees for services.

30. If not justified by the existence of spill-over effects, federal grants run the risk of leading to overspending by the recipients and to efficiency losses, since the true costs of providing goods and services are not reflected in the Länder budgets. This allows sub-central governments to provide their electorates with services and benefits while passing on part of the associated costs to a wider community of tax payers. As discussed in the previous *OECD Economic Survey of Germany*, investment in hospitals serves as an example that a lack of congruency between spending and financing obligations on the side of the Länder can lead to overspending. Hospital capacity is regulated by the Länder which are also responsible for investment expenditures but not for financing operating costs or covering deficits. The lack of financial responsibility of the Länder implies a strong incentive to expand hospital capacity, thereby creating local employment.

31. Overall, it appears that a large share of projects covered by co-determination or investment aid is in fact relevant only for individual states<sup>19</sup>. Hence for a large part of such programmes, spending decisions and financing could be left entirely in the domain of the Länder. After reunification the government reduced its regional aid in the west and concentrated it on eastern Germany<sup>20</sup>. This policy should be considered an opportunity to examine the degree of co-financing and focus it more narrowly, taking into consideration equity goals.

32. Over the last few decades social benefits might have expanded less vigorously into new areas if the budgetary consequences for their funding had been concentrated in a single entity. A review of social spending to determine which benefits could be allowed to vary across regions would be important. Responsibilities for financing could be given entirely to the Länder (and communities) if they are judged to be supplementary at the regional level, or if complete standardisation of provision is considered to be desirable, to the federal government. The restructuring of family benefits in 1996 is an example since child benefits have been deleted from the list of co-financed transfers<sup>21</sup>. If some regional discretion over benefit levels is desired, the Bund could fully finance a basic provision whose topping up could be left to the Länder or communities.

33. At present, federal law standardises the salaries for civil servants across the country, prohibiting state-specific salary adjustments. In view of the fact that outlays for personnel, including pensions, account for about 45 and 40 per cent of current spending of the Länder and the communities, respectively,

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<sup>18</sup>. But the fact that communal road construction is of little importance for inter-state traffic connections suggests leaving the financial responsibilities for road construction in a narrow sense fully with the communities. Interstate road construction is fully paid for by the Bund.

19. For detailed descriptions of federal subsidies provided as investment aid or within the framework of Joint Fiscal Tasks see: Bundesministerium der Finanzen, *Subventionsbericht 1997*, Bonn, 1997.

20. Federal "Support of the Regional Economic Structure" has been reduced from DM 0.5 billion in 1990 to DM 0.4 billion in 1996 in the west while the east received DM 3.7 billion.

<sup>21</sup>. See *OECD Economic Survey of Germany*, 1996.

considerable scope for the Länder and community finances could be gained if this regulation were relaxed, allowing regional pay settlements.

34. Also, new demands and changes in the competitive environment suggest that in some fields services could be provided more efficiently if governments co-operated or were combined into larger administrative units. For example, deregulation in the energy sector implies that demarcation and exclusivity conditions for local suppliers will be dropped (see *OECD Economic Survey of Germany 1996* and chapter IV below). Securing the competitiveness of local utilities (*Stadtwerke*) without subsidisation will require combination across communes of generators into larger units. This, in turn, requires co-operation among the communes which are legally responsible for local energy suppliers.

### ***Taxing powers need to be devolved***

35. Incentives to expand spending, which are inherent in mixed financing, are strengthened by the restricted taxing powers of the Länder and communities. The limited -- and decreasing -- scope to finance additional spending out of own revenues reinforces demands for higher transfers from the federal budget and for increasing tax shares. This tendency is further supported by the strong position the Länder have in the federal legislative process. The fact that all laws which affect the Länder financially or administratively require approval from the upper chamber of parliament can be used for strategic behaviour to increase the states' share in overall revenues. Lack of tax autonomy also increases the risk that the Länder object to general fiscal measures which may have repercussions on federal government transfers. For example, although the proceeds from the "Solidarity" income tax surcharge are not earmarked and accrue exclusively to the federal budget, the Länder initially rejected the government's plan to reduce the surcharge because they feared that transfers to eastern Germany might be curbed.

36. The tax autonomy of sub-central layers of government could be increased by allowing the states and/or communities some discretion with respect to income taxation. This goal could be achieved even if the tax base remains federally defined. Indeed, experience in other OECD member countries indicates that achieving the benefits of decentralised income-taxing while preserving the benefits of an administratively simple tax system requires that core elements of the tax codes be harmonised. In Canada, provinces have managed to preserve a single tax administration while exercising a considerable degree of taxing autonomy. It is evident, however, that allowing tax bases to differ between the various layers of government complicates the administration of taxes and increases the taxpayers' compliance costs. Although Canadian provinces are in principle free to vary their income tax base, preserving administrative efficiency requires a close harmonisation between provincial tax bases and the federal base, which for most provinces is supported by formal agreements. As a consequence, tax competition manifests itself primarily in the provinces' choice of income tax rates<sup>22</sup>. Similarly, in the United States a substantial majority of states define their taxable income bases along the lines of the federal definition. In Switzerland, where compliance costs are potentially high due to a lack of harmonisation in cantonal tax laws, a federal tax harmonisation law came into effect in 1993 giving the federal government a mandate, *inter alia*, for working towards uniform definitions of tax bases.

37. In Germany, with a given uniform tax code for the Federal Republic, an element of tax autonomy with respect to income taxation could be introduced by incorporating a Länder-specific surcharge into any

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<sup>22</sup>. Formally, administrative simplicity and a certain degree of tax harmonisation has been achieved via federal-provincial tax collection agreements. However, provinces are asking for an increasing number of special tax credits and other measures, some of which could have adverse effects on efficiency. See *OECD Economic Survey of Canada, 1997*.

reformed -- and correspondingly reduced -- tax schedule<sup>23</sup>. While compliance costs might be higher than in a completely harmonised system, this setting would require virtually no additional expertise on the side of the tax payer and minimise administrative costs on the side of the tax authorities<sup>24</sup>.

38. It may be argued that regional tax discretion and ensuing tax competition could lead to an erosion of the tax base of poor states. However, as noted above, in the present system states compete already to attract companies by offering various types of costly aid, often cofinanced by the federal government, or -- arguably -- favourably interpreting the federal tax code. Enhancing regional tax autonomy, and the greater tax competition which could ensue, would generally entail a search for savings and increase the transparency of policies. Equity considerations could be incorporated by restricting the maximum size of admissible state-specific surcharges by federal law<sup>25</sup>. On the other hand, in an economy where the ratio of taxes and contributions to national income is already high, enhanced regional tax autonomy should not be taken as implying scope to raise taxes. Indeed the state surcharge in a reduced tax schedule would, as noted, be consistent with the overall aim of reducing the tax burden.

39. Similarly, incentives to reduce the tax burden and balance the costs and benefits of publicly-provided goods would be strengthened by a shift from taxation to a system which relied more strongly than at present on charging fees for services. Most importantly, this matches public service provision to local choice as customers tend to demand more tailored services when they pay for them directly<sup>26</sup>.

### Summing up

40. While co-operation and budgetary independence are simultaneously emphasised in the German constitution, in practice the federal fiscal set-up has evolved towards consensus and co-operation, where equalisation of living standards takes precedence over public choice and economic incentives. While the states and communities do compete with each other to attract economic activity, the scope for expressing regional and local preferences with respect to public spending patterns remains highly restricted. The scope for reducing the burden of taxation by evaluating the marginal tax burdens against spending benefits is even more restricted. Shared taxes and the low reliance on own taxes make for a relatively inefficient control over public spending. In public finance terms, the German system thus does not achieve the allocational benefits which should accrue to a federal fiscal system.

41. At the same time, the system may be criticised for not achieving economic convergence among the states. The difference in regional living standards is smaller than in some other economies, but the fiscal system introduces a high degree of stationarity into the economy where the revenue equalisation

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23. This has been suggested by the Scientific Council at the Ministry of Finance, see, Wissenschaftlichen Beirat beim Bundesministerium der Finanzen, "Gutachten zum Länderfinanzausgleich in der Bundesrepublik Deutschland", *BMF Schriftenreihe 47*, Bonn, 1992.

24. Higher administrative costs can arise with respect to the wage withholding tax if firms employ residents of different states. This would imply either residence-specific withholding rates on the side of the firms, or -- with no such differentiation on the employers' side -- additional filings of tax returns and claims for tax refunds on the side of the tax authorities.

25. With the tax surcharges varying across the Länder, the value of tax concessions could also vary by Land, depending on the type of the concession. Whether or not this would conflict with equity goals (for example in the case of child allowances) is a matter of judgement, taking into consideration that the value of tax concessions would vary inversely with the size of the tax surcharge.

26. OECD members countries are increasingly charging fees for services, a major objective being to relieve tax payers of costs borne by the users who benefit from a service. See OECD, "User charging for government services: best practice guidelines and case studies", *Public Management Occasional Papers 22*, Paris 1998.



system offers no incentives to expand the tax base and may even promote tax avoidance. There has been almost no change in the dispersion of GDP per capita between the states over the last three decades. Greater dynamism could be achieved with a less confiscatory equalisation system and a higher degree of tax autonomy and both of these should form part of any balanced tax and expenditure reform.

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